

A PUBLICATION OF THE NEW JERSEY DIVISION OF PENSIONS AND BENEFITS

The Taxability and Mandatory Withholding of Income Tax from your Pension Distribution

All Funds

This fact sheet summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described below are complex and contain many conditions and exceptions that are not included in this fact sheet. Therefore, you may want to consult with a professional tax advisor before you take a payment of your benefits from your retirement account.

The Division of Pensions and Benefits cannot give tax advice. You can find more specific information on the tax treatment of payments from qualified employer plans in IRS Publication 575, *Pension and Annuity Income*, and IRS Publication 590, *Individual Retirement Arrangements*. These publications are available from your local IRS office, the IRS's Web site at www.irs.gov, or by calling 1-800-TAX-FORMS.

The term IRA used in this fact sheet includes traditional individual retirement accounts and individual retirement annuities. It does **not** include a Roth IRA, SIMPLE IRA, or a Coverdell Education Savings Account (formerly known as an education IRA).

WHAT IS A ROLLOVER?

Payments received from a retirement plan are treated as income subject to income tax for the year in which they are received. You may want to postpone paying income tax on such distributions from your pension plan by placing those payments in a **traditional IRA** or another **eligible employer-sponsored retirement plan**. This procedure is called a "rollover." When you draw funds that have been rolled over out of a traditional IRA or employer plan at a later date, they will then be subject to federal and state income tax.

A traditional IRA does not include a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account (formerly known as an education IRA). Payments cannot be rolled over to these types of IRAs. An "eligible employer plan" includes:

- a plan qualified under section 401(a) of the Internal Revenue Code, including a 401(k) plan, profit-sharing plan, defined benefit plan, stock bonus plan, and money purchase plan;

- a section 403(b) annuity plan; a section 403(b) tax-sheltered annuity; and
- an eligible section 457(b) plan maintained by a governmental employer.

Types of Rollovers

There are two ways you may be able to receive a payment that is eligible for rollover:

- (1) Certain payments can be made directly to a traditional IRA that you establish or to an eligible employer plan that will accept it and hold it for your benefit. This is known as a "**Direct Rollover**."
- (2) The payment can be **paid to you**. Payments that you accept are subject to federal tax withholding. You have the option, within 60 days of receipt, of rolling over payments that are made to you. This is known as an "**Indirect Rollover**."

Both Direct and Indirect Rollovers are discussed later in this fact sheet.

**WHAT TYPES OF PAYMENTS
CAN BE ROLLED OVER?**

Taxable and certain non-taxable distributions from the State retirement systems may be rolled over. These include:

- Lump-sum withdrawals of member contributions;
- Lump-sum death payments to a spouse; and
- Annuity payments to spousal beneficiaries under five year certain options.

The amount eligible for rollover is the accumulation of any before-tax and after-tax contributions to the pension plan, and all earnings on the account.

Special Rules for After-tax Contributions

If you made after-tax contributions to the pension plan, these contributions may be rolled into either a traditional IRA or to certain employer plans that accept rollovers of after-tax contributions. The following rules apply:

Rollover into a Traditional IRA - You can roll over your after-tax contributions to a traditional IRA either directly or indirectly.

If you roll over after-tax contributions to a traditional IRA, it is your responsibility to keep track of, and properly report the amount of these after-tax contributions to the IRS. This will enable the nontaxable amount of any future distributions from the traditional IRA to be determined.

Once you roll over after-tax contributions to a traditional IRA, that money CANNOT later be rolled over to an employer plan.

Rollover into an Employer Plan - You can roll over after-tax contributions from the pension plan using a Direct Rollover if the other plan provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions. You CANNOT, however, roll over after-tax contributions from a pension plan to a 403 (b) tax sheltered annuity or governmental 457 plan. You can, however, roll

over after-tax contributions from a Section 403 (b) tax-sheltered annuity to another Section 403 (b) tax-sheltered annuity using a Direct Rollover.

If you want to roll over your after-tax contributions to an employer plan that accepts these rollovers, you cannot have the after-tax contributions paid to you first. You must instruct the administrator of the pension plan to make a direct rollover on your behalf. Also, you cannot first roll over after-tax contributions to a traditional IRA and then roll over that amount into an employer plan.

Qualified Voluntary Employee Contributions

In addition to before-tax and after-tax salary deductions for the regular retirement system, some employees had salary deductions for an optional Qualified Voluntary Employee Contribution (QVEC) plan. Benefit payments made from a QVEC plan under one of the payment options listed above are eligible for rollover to an IRA, but not to an employer-sponsored retirement plan. Federal income tax withheld from QVEC distributions is optional. You either elect to have tax withheld or not. The applicable tax is calculated using the prescribed IRS tax rates.

**WHAT TYPES OF PAYMENTS
CANNOT BE ROLLED OVER?****Payments Spread Over Long Periods**

You cannot roll over a taxable distribution if it is part of a series of equal (or almost equal) payments that are made at least once a year and that will last for your lifetime or life expectancy; your lifetime and your beneficiary's lifetime or life expectancies; or a period of ten or more years.

Required Minimum Payments

Beginning when you reach age 70½ or retire, whichever is later, a certain portion of your payment cannot be rolled over because it is a "required minimum payment" that must be paid to you.

Loans Treated as Distributions

The amount of a pension plan loan that becomes a "taxable deemed distribution" because of a default

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cannot be rolled over.

HOW DO I ARRANGE FOR A DIRECT ROLLOVER OF MY PAYMENT?

You can choose a direct rollover of all or any portion of your payment that is an eligible rollover distribution as described in the previous sections. In a Direct Rollover, the eligible rollover distribution is paid directly from the retirement system to an IRA or another eligible employer plan that accepts rollovers. If you choose a Direct Rollover, you are not taxed on a payment until you later take it out of the IRA or the other eligible employer plan. In addition, no income tax withholding is required for any taxable portion of your plan benefits if you choose a Direct Rollover.

Direct Rollover to a Traditional IRA

You can open an IRA to receive the Direct Rollover. If you choose to have payment made directly to an IRA, contact the IRA sponsor (usually a financial institution) to find out how to have your payment made in a Direct Rollover to an IRA at that institution. If you are unsure how to invest your money, you can temporarily establish an IRA to receive payment. In choosing an IRA, you may wish to consider whether the IRA you choose will allow you to move all or a part of your payment to another IRA at a later date without penalties or limitation. See IRS Publication 590, *Individual Retirement Arrangements*, for more information on traditional IRAs (including limits on how often you can roll over between IRAs).

If you roll over after-tax contributions to a traditional IRA, that money cannot later be rolled over to an employer plan.

Direct Rollover to an Employer Plan

If you are employed by a new employer that has an eligible employer plan, and you want a Direct Rollover to that plan, ask the administrator of that plan whether it will accept your rollover. If your new employer's plan does not accept rollovers, you can choose a Direct Rollover to an IRA.

An eligible employer plan is not legally required to accept a rollover. Before you decide to roll over

your payment to another employer plan, you should find out whether the plan accepts rollovers and, if so, the types of distributions it accepts as a rollover. You should also find out about any documents that are required to be completed before the receiving plan will accept a rollover. Even if a plan accepts rollovers, it might not accept rollovers of certain types of distributions, such as after-tax amounts. If this is the case, and your distribution includes after-tax amounts, you may wish to roll your distribution over to a traditional IRA or split your rollover amount between the employer plan in which you will participate and a traditional IRA. If an employer plan accepts your rollover, the plan may restrict subsequent distributions of the rollover amount or may require your spouse's consent for any subsequent distribution. A subsequent distribution from a plan that accepts your rollover may also be subject to different tax treatment than distributions from the pension plan. Check with the administrator of the plan that is to receive your rollover prior to making the rollover.

Direct Rollover of a Series of Payments

If you receive eligible rollover distributions that are paid in a series of less than ten years, your choice to make or not make a Direct Rollover for a payment will apply to all later payments unless you change your election. You are free to change your election for any later payments in the series. Contact your plan for further information or how to change your election.

Change in Tax Treatment Resulting from a Direct Rollover

The tax treatment of any payment from the eligible employer plan or traditional IRA receiving your Direct Rollover might be different than if you received your benefit in a taxable distribution directly from this pension plan. For example, if you were born before January 1, 1936, you might be entitled to ten-year averaging or capital gain treatment (explained on page 5). However, if you have your benefit rolled over to a section 403(b) tax-sheltered annuity, a governmental 457 plan, or a traditional IRA in a Direct Rollover, your benefit will no longer

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be eligible for that special treatment.

**WHAT HAPPENS IF I HAVE THE
PAYMENT PAID TO ME?**

If you have the payment made to you, the taxable portion is subject to 20 percent federal income tax withholding. The taxable distribution is taxed in the year you receive it unless, within 60 days, you roll it over to an IRA or another eligible employer plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

**WHAT ARE THE SPECIAL TAX RULES WHEN
THE PAYMENT IS MADE DIRECTLY TO ME?****Mandatory Withholding**

If any portion of the payment to you is an eligible rollover distribution, the retirement system is required by law to withhold 20 percent of the amount. This amount is sent to the IRS as income tax withholding.

For example, if your eligible rollover distribution is \$10,000, only \$8,000 will be paid to you because the retirement system must withhold \$2,000 as income tax. When you prepare your income tax return for the year, you will report the full \$10,000 as a payment from the retirement system. You will report the \$2,000 as tax withheld and it will be credited against any income tax you owe for the year.

You may determine the taxable amount of any withdrawal you make by calling the Office of Client Services' Automated Information System (using a touch-tone telephone) at (609) 777-1777.

Voluntary Withholding

If any portion of your payment is not an eligible rollover distribution and is taxable (such as the payment to a non-spousal beneficiary of an active death benefit or Option 1 retirement settlement), the mandatory withholding rules described above **do not apply**. In this case, you may elect to not have the withholding apply to that portion. To elect out of withholding, you must complete a withholding certificate.

If you do not complete this form, we will withhold tax at 10 percent.

**WHAT IF I HAVE THE TAXABLE
DISTRIBUTION MADE TO ME AND CHANGE
MY MIND AFTER I RECEIVE IT?**

You have a 60-day rollover option. If you have an eligible rollover distribution paid to you, you can still decide to roll over all or part of it to an IRA or another eligible employer plan that accepts rollovers. You must make the rollover within 60 days of the date you receive the payment. The rollover will not be taxed until you take it out of the IRA or the employer plan.

You can roll over up to 100 percent of the eligible rollover distribution, including an amount equal to the 20 percent tax withholding. If you choose to roll over 100 percent, you must find other money within the 60-day period to contribute to the IRA or the eligible employer plan to replace the 20 percent that was withheld.

For example: Your eligible rollover distribution is \$10,000 and you choose to have it paid to you. You will receive \$8,000 and \$2,000 will be sent to the IRS as income tax withholding. Within 60 days after receiving the \$8,000, you may roll over the entire \$10,000 to an IRA or eligible rollover plan. To do this, you roll over the \$8,000 you received from the retirement system and you add \$2,000 from other sources (your savings, a loan, etc.). In this case, the entire \$10,000 is not taxed until you take it out of the IRA or employer plan. When you file your income tax return, you report the \$2,000 of tax withheld. Alternately, if you roll over only \$8,000, the \$2,000 not rolled over is taxed in the year it was withheld. When you file your income tax return, you may get a refund of part of the \$2,000 withheld. (However, any refund is likely to be larger if you roll over the entire \$10,000.)

**IF I HAVE THE TAXABLE DISTRIBUTION
MADE DIRECTLY TO ME, IS THERE A
PENALTY FOR EARLY WITHDRAWAL?**

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If you receive a payment before you reach age 59½ and you do not roll it over, then, in addition to the regular income tax, you may have to pay an extra tax equal to 10 percent of the taxable portion of any payment. This does not apply if the payment is:

- paid to you because you separate from employment with your employer during or after the year you reach age 55.
- paid to you because you retire due to disability.
- paid to you as equal (or almost equal) payments over your life or life expectancy (or your beneficiary's life or life expectancy).
- used to pay certain medical expenses and does not exceed the amount of your deductible medical expenses.
- paid directly to the government to satisfy a federal tax levy.
- paid to an alternate payee under a qualified domestic relations order.

See IRS *Form 5329* for more information on the additional 10 percent tax.

The additional 10 percent tax will not apply to distributions from a governmental 457 plan, except to the extent the distribution is attributable to an amount you rolled over to that plan (adjusted for investment returns) from another type of eligible employer plan or IRA. Any amount rolled over from a governmental 457 plan to another type of eligible employer plan or to a traditional IRA will become subject to the additional 10 percent tax if it is distributed to you before you reach age 59½, unless one of the exceptions listed above applies.

SHOULD I BE AWARE OF ANY OTHER SPECIAL TAX TREATMENTS?

If your eligible rollover distribution is not rolled over, it will be taxed in the year you receive it. If it qualifies as a lump-sum distribution, it may be eligible for special tax treatment. A lump-sum distribution is a payment, within one year, of your entire balance under the retirement system that is payable to you because you have reached age 59½ or have separated from service with your employer. For a payment to qualify as a lump-sum distribution, you must have been a

participant in the retirement system for at least five years. The special tax treatment for lump-sum distributions is described below.

If You Were Born Before January 1, 1936

Ten-year Averaging - if you receive a lump-sum distribution and you were born before January 1, 1936, you can make a one-time election to figure the tax on the payment by using ten-year averaging (using 1986 tax rates). This often reduces the tax you owe.

Capital Gain Treatment - in addition, if you receive a lump-sum distribution and you were born before January 1, 1936, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the retirement system (if any) taxed as long term capital gain at a rate of 20 percent.

There are limits on the special tax treatment for lump-sum distributions. For example: You can generally elect this special tax treatment only once in your lifetime and the election applies to all lump-sum distributions that you receive in that same year. You may not elect this special tax treatment if you rolled amounts into this plan from a 403(b) tax-sheltered annuity contract or from an IRA not originally attributable to a qualified employer plan. If you have previously rolled over a payment from the retirement system (or another employer plan), you cannot use this special treatment for later payments. If you roll over your payment to a traditional IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, you will not be able to use this special tax treatment for later payments from that IRA, plan, or annuity. Also, if you roll over only a portion of your payment to a traditional IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, this treatment is not available for the rest of the payment. See IRS *Form 4972* for additional information on lump-sum distributions and how to elect the special tax treatment.

WHO IS AFFECTED BY THESE TAX RULES?

In general, the rules summarized above apply to payments to employees and surviving spouses of employees and to spouses or former spouses who are alternate payees. You are an alternate payee if your interest in the retirement system results from a qualified domestic relations order issued by a court,

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usually in connection with a divorce or legal separation. If you are a surviving spouse or an alternative payee, you may choose to have a payment that can be rolled over, as described above, paid in a Direct Rollover to a traditional IRA or to an eligible employer plan or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to a traditional IRA or to an eligible employer plan. Thus you have the same choices as the employee.

If you are a beneficiary other than a surviving spouse, you cannot choose a Direct Rollover, and you cannot roll over the payment yourself.

If you are a surviving spouse, an alternate payee, or another beneficiary, payment is generally not subject to the additional 10 percent tax described previously, even if you are younger than 59½.

If you are a surviving spouse, an alternate payee, or another beneficiary, you may be able to use the special tax treatment for lump-sum distributions described previously. If you receive a payment because of the employee's death, you may be able

to treat the payment as a lump-sum distribution if the employee met the appropriate age requirements, whether or not the employee had five years of participation in the pension plan.

**HOW WILL MY OUTSTANDING LOAN
BALANCE AFFECT MY DISTRIBUTION?**

Your outstanding loan is part of your pension distribution and all or part of your loan may be taxable. As such, 20 percent withholding will be computed on the taxable portion of the loan and deducted from your cash settlement if you choose a Direct Rollover. If you choose to do a Direct Rollover, you have the option of paying off the loan prior to the settlement of your account. If you do not pay off the loan, we will process a partial transfer with available funds in your account after 20 percent withholding has been applied to the outstanding loan. You will then be taxed on the taxable portion of your distribution not directly transferred unless you roll over the balance to a traditional IRA or new employer plan within 60 days of the distribution from the Division of Pensions

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